

Delaware Legislation Renews Interest in Captives

W. Harding (Hardy) Drane, Jr., B. Janell Grenier and
Arris Reddick Murphy

In recent years, due to dramatic increases in insurance premiums and growing difficulty in securing certain types of insurance coverage, many companies have formed captive insurance companies as an alternative risk transfer tool, and others are considering doing so. Although captive insurance companies are now offered in a variety of business models and are formed under various entity types, a captive insurance company is, in its purest form, a company that is established as a subsidiary of a parent company to insure the risks of its parent.

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W. Harding Drane, Jr. (302-984-6019 or wdrane@potteranderson.com) is a partner, B. Janell Grenier (302-984-6193 or jgrenier@potteranderson.com) is Special Benefits Counsel and Arris Reddick Murphy (302-984-6183 or amurphy@potteranderson.com) is an associate at Potter Anderson & Corroon LLP.

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Delaware recently revised its captive insurance legislation. The 2005 revision to Delaware’s captive insurance legislation (the “Delaware Act”)[1] represented the first major overhaul since Delaware enacted its original captive insurance law in 1984.[2] The revised legislation resulted from a unique collaboration between government and the private sector.[3] The new captive insurance statute captures the three “Rs” of an effective captive insurance regulatory environment – Responsible, Reasonable and Responsive.

- **Responsible** – the statute is well-defined, self-contained and offers captive owners clear principles upon which to establish business practices. Delaware’s dedication of a regulatory division to captive insurance companies fosters a level of regulatory predictability.
- **Reasonable** – the Delaware statute is comparable to and, in many respects, more attractive than laws in competing domestic domiciles, as the Delaware Act (i) allows captives to be formed under the laws of any jurisdiction yet still be domiciled in Delaware, (ii) permits captives to be formed not only as corporations but also as other types of entities such as LLCs, partnerships, and statutory trusts, and (iii) assesses a simple, flat, and capped premium tax.
- **Responsive** – the statute provides the Delaware Insurance Commissioner with discretion to expand, limit or prohibit certain captive activities, and thus tailor regulatory requirements to fit the individual captive’s operations and business model.

The trend toward establishing captive insurance companies was initially sparked by companies seeking to use captives as tax-reduction vehicles. Over the years, however, many companies have turned to captives because certain of their insurance premiums have risen significantly, despite the company’s historical low claims and loss levels. More and more companies are establishing captives to insure a variety of risks, including property and casualty, general and auto liability, product liability, and employee benefits such as long-term care and supplemental life insurance plans. And, the recent revisions to the Delaware Act along with a softened approach in the Department of Labor’s stance regarding the use of captives for employee benefit plans (as discussed below) make this an opportune time to revisit captives as viable alternative risk management tools.

1313 North Market Street

P.O. Box 951

Wilmington, DE 19899-0951

(302) 984-6000

www.potteranderson.com

Benefit plan captives raise prohibited transaction concerns. Employee benefit captives are among the newer uses of captives and may be advantageous for group term life, and short-term and long-term disability. However, in an effort to protect employees and their benefits, the Employee Retirement Income Security Act of 1974, as amended (“ERISA”) prohibits fiduciaries or employer-sponsors of benefit plans from engaging in financial transactions with “parties in interest” that involve plan assets.[4] Therefore, because an employer’s captive insurance company falls within the definition of a party in interest, absent an exemption to the prohibited transaction rules, the captive could generally not participate in an insurance or reinsurance of its parent’s benefit plan liabilities.

Fortunately, in 1979, the Department of Labor (“DOL”) granted a class exemption to the prohibited transaction rules, thereby providing that the restrictions under ERISA shall not apply to the sale of insurance contracts by an insurance company which is a party in interest to the plan, if the insurance company making the sale (i) is licensed in at least one state, (ii) has obtained a Certificate of Compliance from the insurance commissioner, (iii) has undergone an examination by an independent certified public accountant, and (iv) more than 50% of the captive’s gross premiums are attributable to unrelated third-party business.[5] The most difficult requirement of the class exemption to meet is the unrelated business requirement, which the DOL imposed in order to enhance the financial soundness of the captive and protect the benefit plan against abusive transactions.

Individual DOL exemption relaxes the 50% unrelated business requirement. While the DOL has not abandoned the 50% unrelated business test, the individual exemptions granted to Columbia Energy (August 2000), Archer Daniels Midland (May 2003), and several others (more recently) recognize other acceptable means for protecting the benefit plans. Accordingly, alternative requirements were mandated, such as, that the fronting insurer must have a rating from A.M. Best of “A” or better, an independent fiduciary must be appointed to analyze the transaction, and the transaction shall provide a benefit enhancement for employees. Only the employers that have applied for and received approval from the DOL may rely on these exemptions.[6] However, it is reasonable to expect that the DOL will now grant exemptions more quickly, through its expedited process, for employers who want to utilize a captive under substantially similar fact scenarios.

The numerous and potentially complex issues that are involved with the formation and operation of captives in general, and the additional complexities that employee benefit plan captives can create, make it wise to “look before you leap.” A well-planned feasibility study, including consultation with experienced actuaries, attorneys and accountants, is a necessary initial step in deciding whether to form a captive. Once it is determined that a captive is a viable option, Delaware should be on the short list of potential domiciles for companies considering the creation of a captive as part of their risk management plan. Delaware should also receive serious consideration as a domicile for companies that are considering re-domesticating or re-domiciling an existing captive, and for those service providers that render advice, conduct feasibility studies or offer related captive insurance services.

[1] 18 Del.C. §§ 6901 et seq. (2006); 75 Del. Laws, c. 150, § 1.

[2] HB 218, 143rd Gen. Assembly (DE 2005) (Synopsis).

[3] HB 218, supra note 2; see also 143rd General Assembly: House Bill #218 w/HA 1, [http://legis.state.de.us/LIS/LIS 143.nsf/vw Legislation/HB & 218?Opendocument](http://legis.state.de.us/LIS/LIS%20143.nsf/vw%20Legislation/HB%20218?Opendocument) (detailed Bill tracking history with committee reports).

[4] The rules under 29 U.S.C. §1106(a) prohibit transactions between a plan and a party in interest, and §1106(b) prohibits transactions between a plan and a fiduciary. A “party in interest” is any plan fiduciary, employer-sponsor, or person providing services to the plan, including counsel. Also see “disqualified person” under 26 U.S.C. §4975(e).

[5] Prohibited Transaction Class Exemption 79-41 (44 FR 46365, published August 7, 1979).

[6] Individual exemptions may be relied on only by the parties so exempted. DOL Reg. §2570.49(c).

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